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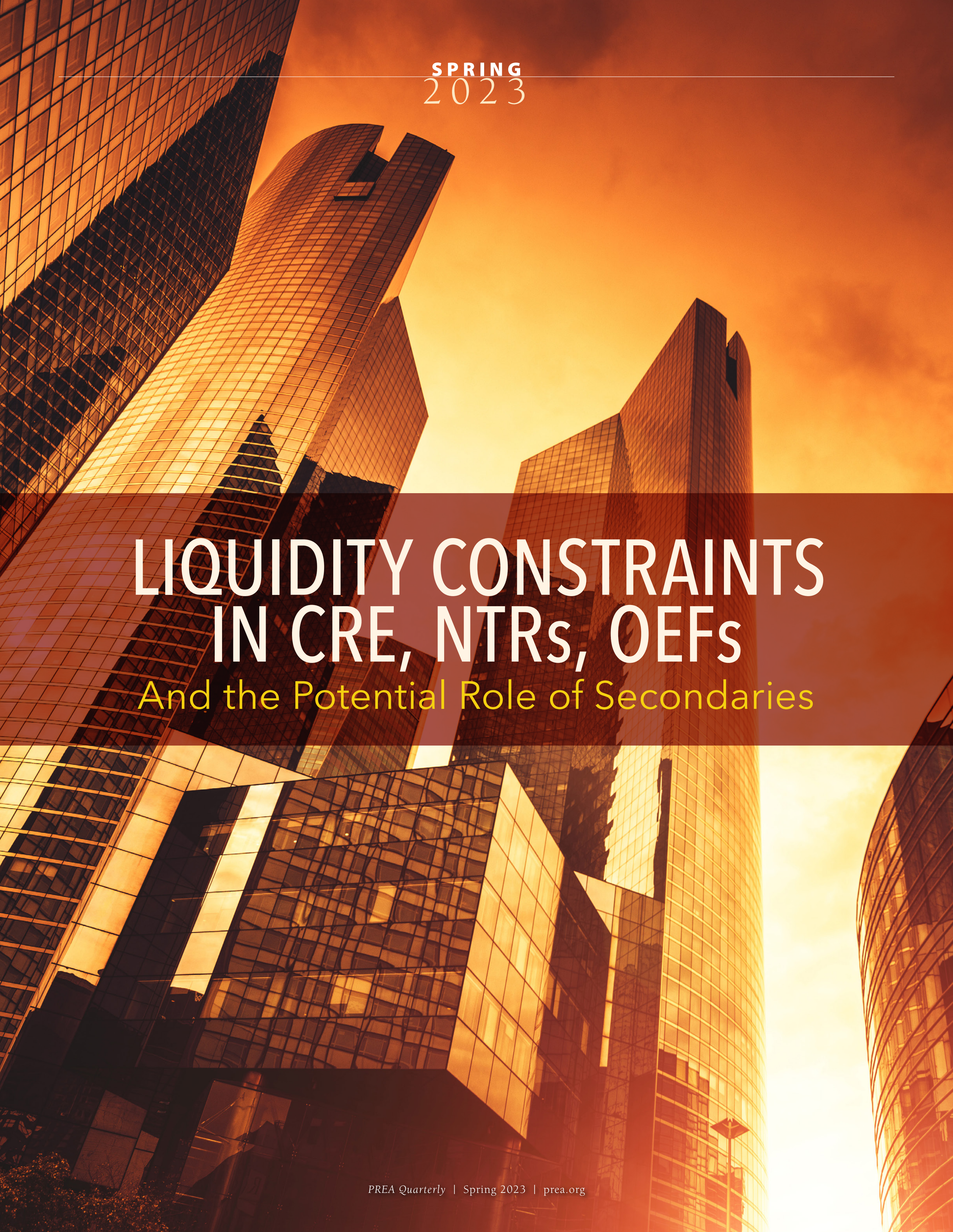

LIQUIDITY CONSTRAINTS IN CRE, NTRs, OEFs

And the Potential Role of Secondaries

The Federal Reserve has embarked on the fastest pace of rate hikes since the Whip Inflation Now era of the 1970s …

Christopher Muoio
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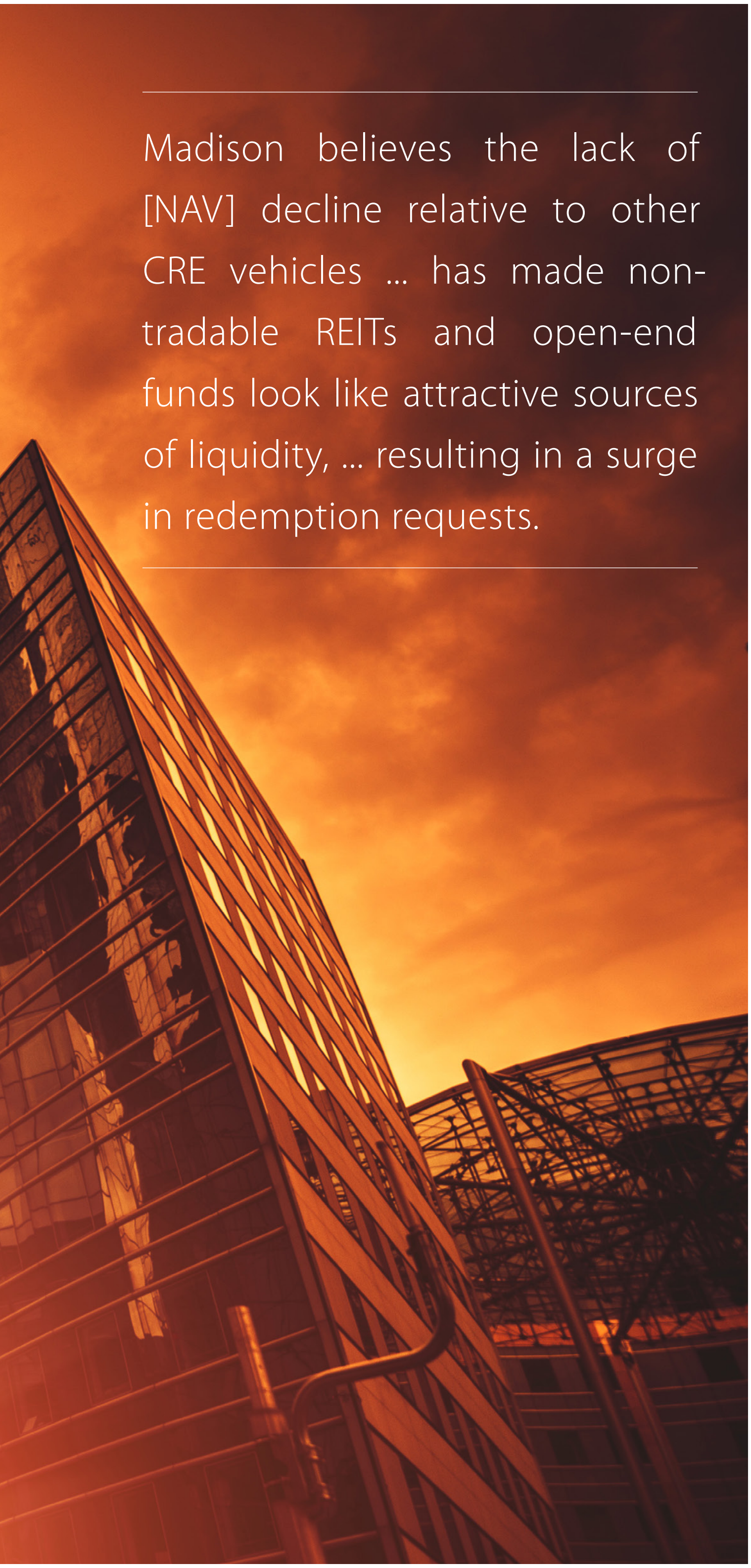
Over the past year, global central banks have initiated aggressive monetary intervention to tamp down inflation that had run rampant because of a confluence of factors, including the COVID-19 pandemic and reopening. The Federal Reserve has embarked on the fastest pace of rate hikes since the Whip Inflation Now era of the 1970s, the Bank of England is hiking at its fastest pace since the Thatcher era in the 1980s, and the European Central Bank has tightened the fastest in the history of the EU trading bloc. All told, central bank rates have risen by 500 basis points (bps) in the US, 425 bps in the UK, and 350 bps in the EU[1] over the past year and a half, resulting in capital market volatility and a rapid shift in the cost of financing and capital markets environment for commercial real estate. Madison believes that the dramatic shift in monetary policy and its impact on commercial real estate (CRE) deal flow and valuations has created liquidity needs for investors, particularly those invested in non-traded REITs, open-end funds, and other closed-end CRE vehicles. The sponsors of these vehicles likely will not have sufficient capitalization to meet the liquidity requirements of their investors in the short-term, creating a need for secondary liquidity providers.

Capital Constraints Spur Public-Private Valuation Mismatch

Private market CRE liquidity has declined dramatically over the past year as interest rates rose swiftly while deal volume (excluding entity-level transactions) fell 59% year over year,[2] and CMBS issuance declined 74% year to date.[3] Underscoring how steep the drop in CRE capital markets conditions has been, Madison's proprietary MIR Liquidity Index (which calculates a binary growth score of CRE market liquidity based on 15 variables encapsulating deal flow, public markets, pricing, and fundraising activity) has fallen to its lowest level since the aftermath of the great financial crisis in 4Q2009, with 9 of 15 components showing declining liquidity. Meanwhile, a bid-ask spread has emerged as potential buyers adjust to the shifts in financing costs and cap rates face upward pressure from rising interest rates, while sellers point to historical comparables at higher valuations. Madison believes this pricing differential and lack of liquidity has resulted in valuations adjusting more slowly in the private markets than in publicly listed REITs.

Listed REIT valuations have fallen 27% in the US from their 2021 peak, according to the FTSE NAREIT All Equity Index,[4] and 36% in Europe, according to the MSCI Europe Real Estate Index. Private markets have fallen just 9.3% from peak valuations, per the RCA Commercial Property Price Index (CPPI), an index based on private repeat sales.[5] Per RCA's hedonic cap rate series, private market cap rates have risen just 20 bps across the four major sectors (office, industrial, retail, and apartment) from their trough last year to the fourth quarter of 2022. That compares to a rise of 230 bps in implied REIT cap rates, per the Green Street equal-weighted market average over the same time horizon.

1. Bloomberg data as of April 12, 2023.
2. Real Capital Analytics as of March 2023.
3. Bloomberg data as of March 31, 2023.
4. Bloomberg data as April 12, 2023.
5. Real Capital Analytics as of March 2023.



The valuation gap to listed REITs is even wider when looking at the current valuations of non-traded REITs and open-end funds. The NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE) has declined only 5% from its peak valuation[6] in 3Q2022, while some of the largest non-tradable REITs, such as BREIT (Blackstone Real Estate Income Trust) and AREIT (Ares Real Estate Income Trust), have marked down NAV by only 2.1%[7] and 2.2%, respectively,[8] from their peaks in 3Q2022 through the end of 1Q2023—significantly less than the private market declines of 9.3% and 15% observed by RCA and Green Street from their peaks in 3Q2022 through the end of 1Q2023. Madison believes the lack of net asset value (NAV) decline relative to other CRE vehicles, as well as increased public market volatility, has made non-tradable REITs and open-end funds look like attractive sources of liquidity for investors (exacerbated by their retail investor profile), resulting in a surge in redemption requests. Accordingly, there is $20 billion in withdrawal requests for NFI-ODCE funds, per the most recent NCREIF data available, and one prominent open-end fund reportedly faced a redemption queue as high as 40% of its value at one point.[9] Additionally, the four largest US non-tradable REITs today face queues greater than 70% of their current fundraising/dividend reinvestment programs.[10] These high withdrawal request levels have prompted mega sponsors such as Blackstone, Starwood, and KKR to gate redemptions. BREIT, for example, saw redemption requests rise from $711 million in 1Q2022 to $13.6 billion in 1Q2023. Prior to Nov. 2022, BREIT met 100% of investor redemption requests, but it hit its stated redemption cap of 5% of NAV per quarter in each of the past two quarters, fulfilling just 29% of investor redemption requests to date.[11] Currently, BREIT has $15.6 billion in unmet redemption requests since Oct. 2022.[12]

6. Bloomberg data as of April 12, 2023.
7. BREIT filings as of Feb. 2023.
8. AREIT filings as of Feb. 2023.
9. *Bloomberg News* as of 17 Jan. 2023.
10. *The Stanger Report* as of 20 Jan. 2023.
11. BREIT SEC filings as of Feb. 2023.
12. BREIT SEC filings as of Feb. 2023.

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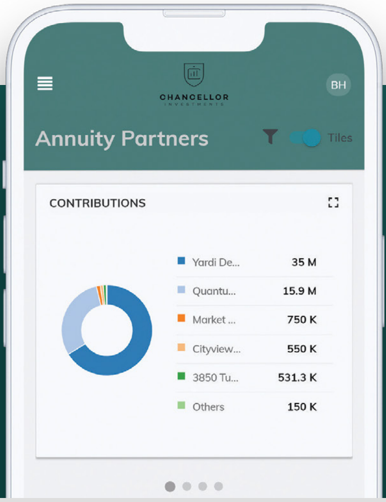

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Stalled Fundraising Has Exacerbated Liquidity Shortfall

Madison believes a key aspect driving the imbalance in redemptions has been a marked downshift in real estate fundraising, which began in 2022 and accelerated in 1Q2023. Historically, robust fundraising, portfolio cash flows, and asset sales were more than sufficient to meet investor redemption requests; however, fundraising has declined alongside liquidity. A total of $182.2 billion was raised for real estate–focused private funds and strategies in 2022, down 17.6% from the year prior.[13] The fundraising environment has become even more challenging this year as capital allocators reevaluate their exposures and grapple with things such as valuation declines in public securities and other liquid instruments creating a denominator effect, making them overallocated to private investments such as real estate, where valuations have lagged. As a result, fundraising totaled just $21 billion in the first quarter, down 56% from a year ago, 7.8% below the COVID-19 nadir in 2020, and the lowest quarterly total since the third quarter of 2014.[14] Non-traded REIT fundraising has seen an even more dramatic decline than the industry as a whole. AREIT, for example, has witnessed fundraising declines for seven consecutive months and is down 80% from a year ago.[15] BREIT has been similarly impacted (excluding the recent joint venture with the University of California Retirement System), with fundraising down in ten of the last eleven months and 93% from a year ago. Notably, BREIT's $4.5 billion raise from the University of California, is sufficient to meet only 1.2 months of redemption requests at the pace observed over the fourth quarter of 2022 and first quarter of 2023.[16]

More Secondary Investment Needed to Fill Liquidity Gaps

Given the high investor demand for liquidity in non-tradable REITs and open-end funds alongside these vehicles' current inability to fundraise or sell assets at a scale necessary to meet the strong redemption demand, Madison believes that secondary transactions and marketplaces are needed and will emerge to bridge the divide. Already, BREIT and SREIT (Starwood Real Estate Income Trust) shares are listed on LODAS Markets, an online real estate transaction platform, with a BREIT transaction occurring 0.3% below the listed NAV at the time[17] (although how much volume transacted at this price is unclear). Madison believes that LODAS and other secondary markets such as Orchard Securities' Central Trade and Transfer program will continue to see rising interest in listing and transacting in shares of these and other similar vehicles. Currently, these marketplaces are relatively anonymous, but Madison expects them to gain increased visibility as they become viable liquidity options, particularly for retail investors. We expect that institutional sellers will have more formal and direct interactions with institutional investors, who will consider doing direct secondaries or tender offers to help meet the demand for liquidity.

However, Madison believes it is unlikely that these transactions will occur as close to NAV as the LODAS Markets' BREIT transaction did in March, with pricing having the potential to be at a discount closer to that observed in private markets or implied public market pricing, especially at an institutional scale. Investors will then face a choice of securing liquidity at a discount to stated NAV or waiting in the queue to get redemption at what could be declining NAVs in the near-term and bearing the interim opportunity cost of not being able to recycle this capital into other CRE opportunities at a lower basis or into other asset classes entirely. Although an improvement in deal volume or fundraising could alleviate the situation and accelerate the pace of redemptions fulfilled, Madison believes that in the interim, a secondary market will necessarily arise to provide liquidity for those that need it, albeit at discounted pricing to reflect prevailing market cap rates and private market valuations. ■

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13. Preqin data as of April 17, 2023.
14. Preqin data as of April 17, 2023.
15. AREIT SEC filings as of Feb. 2023.
16. BREIT SEC filings, MIR calculations as of Feb. 2023.
17. LODAS Markets press release as of March 2023.